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SUBJECT: LITHUANIA'S ECONOMY SLOWING BUT NO DIRE SITUATION (YET)

REF: A. VILNIUS 962
¶B. VILNIUS 866
¶C. VILNIUS 858

¶1. Summary. Economic growth is slowing and unemployment is rising, with mixed news for retailers. Banks continue to lend but are stingy with some sectors and charge more for everyone. What happens with Lithuania's neighbors matters, not just as export markets, but for international and domestic perception of the Lithuanian economy. Fortunately, the new center right coalition government has a fiscal austerity plan to address the budget deficit left by its predecessor and that may leave the country in a good position when the economy improves. End summary.

NO HARD BRAKING BUT SLOWING DOWN

¶2. Recent economic indicators confirm that economic growth is slowing, as expected. GDP growth dropped from 5.2 percent in the second quarter to 3.1 percent in the third. Inflation remains high at 10.5 percent in October. However, Lithuania more than halved its current account deficit (CAD) from the second quarter level of 16.8 percent to 7.2 percent for the third quarter.

¶3. Unemployment figures for the third quarter are not yet available but the press reports that the GOL's Labor Exchange saw a doubling of notification of layoffs from a previous average of 7 or 8 monthly layoff notifications to twenty in October. Ruta Rodzko, the Head of the Macroeconomic and Forecasting Division at the Bank of Lithuania, told us that unemployment is predicted to rise from its current 4.5 percent level to 8 percent next year. Lithuanians leaving the large communities in the UK and Ireland due to economic difficulties there could drive this figure even higher. Representatives of industry groups and major American companies tell us they are hearing talk of layoffs. A local architect told us that his firm has ceased receiving construction design orders, while just a year ago he considered increasing staff to cope with increased demand. Also, an accountant at a local building firm told us that his company had eliminated staff and cut wages for remaining workers by 30 percent. Jekaterina Rojaka, an economic analyst at DnB Nord Bank, said that the investment banks Invalda and Finasta have let people go and that refrigerator maker Snaige and the fertilizer company Achema, both big players in the manufacturing sector, might decide to eliminate staff. Press reports on November 24th said Snaige will cut staff by the end of the year.

¶4. The Director of the Lithuanian Retailer's Association, Marius Basiulis, told us that retailers began preparing for a slowdown six months ago by transferring staff amongst different divisions. More recently, though, one of the main shopping malls in Vilnius, Akropolis, told its tenants that they would have to pay twenty percent more for rent.

Basiulis said this was proof that Akropolis is not concerned about losing tenants, even in more difficult economic times. Basiulis admitted that profits have declined for retail centers but said they remain in the black. Rojaka echoed Basiulis's comments about Akropolis but said her understanding is that some retail space vendors are sweetening offers for prospective tenants by providing fully outfitted spaces versus the past practice of simple cement boxes with utility hookups. Giedrius Miliauskas, a local economics professor, said that car dealers in Lithuania were offering 20 percent discounts to move inventory. For retailers in Lithuania, like in the United States, much will depend on holiday results, as according to Basiulis thirty percent of Lithuanian retailers' sales are at Christmas.

BANKERS' TRUST?

¶5. Banks are still lending, according to a number of interlocutors, but are much more careful as to who they lend to and charge more for the service. Basiulis said retailers are still able to get loans for store upgrades but the process is done on a case by case basis. Interbank lending, like the rest of the world, has receded in Lithuania and is more expensive than before with the latest interest rate of 8.3 percent according to Miliauskas. Data from the Bank of Lithuania shows a modest rise for most interest rates for loans, excepting loans for non-financial corporations in LTL that are in excess of 1 million Litas. These loans had an interest rate of 11.69 percent in September of 2008 vs. 6.17 percent in September of 2007. Multi year mortgage loans in LTL were at 5.97 percent in September of 2008 vs. 5.94 percent a year earlier. Multi year mortgage loans in Euros

were 6.08 percent in September 2008 vs. 5.53 percent a year earlier; an important indicator as Rojaka mentioned that about 55 percent of loans in Lithuanian bank portfolios are in Euros. Rojaka said that a lot of banks are no longer offering loans on a fixed rate but are recalculating loan rates every 3 months, 6 months or 1 year, depending on the recalculation term selected by the loan recipient.

¶6. Credit is still growing in Lithuania. Rojaka told us that overall credit is forecasted to grow 22 to 24 percent in Lithuania this year versus the last, with 12 percent growth forecasted for next year. In addition, the Bank of Lithuania's recent cut of the reserve requirement from 6 to 4 percent provided an approximate 1 billion LTL (about 360 million USD) for lending. Not all banks will use the extra funds to extend more loans, according to Rojaka and Mindaugas Leika, the head of the Financial Stability Division at the Bank of Lithuania, but both felt it was a positive step.

¶7. Rojaka told us that the construction, real estate and transportation, especially truck leasing, sectors face difficulty obtaining credit. Nonetheless, agriculture and manufacturing are still able to obtain loans. Established businesses aren't shocked by the rise in rates according to Rojaka; they lived through a rate rise in 2000. It is the small and medium enterprises (SMEs) that were founded in the last few years of heady growth and unbridled optimism that have had to adjust their expectations.

WHAT HAPPENS NEXT DOOR MATTERS

¶8. Latvia is Lithuania's second largest export market after Russia and both are experiencing weakening economic outlooks. Fortunately, the Parex Bank nationalization by the Latvian government had limited real effect upon the Lithuanian banking system as this institution holds only a 2 percent share of the Lithuanian market. What happens in Latvia, however, does affect the perceptions of the Lithuanian citizenry. Miliauskas told us he was very concerned that if the Latvians were forced to devalue their currency Lithuania

could follow suit not because its economic indicators necessitated such a move but because panicked decision making by a rattled Lithuanian populace could force the GOL to make a drastic move. Nonetheless, Leika stated that Lithuania's declining CAD helped to provide more security that devaluation was unlikely.

¶9. News of the international financial crisis coupled with worries about the health of the Latvian economy might have prompted some Lithuanians to withdraw money from banks. Leika said that in the last month 2.6 billion LTL or about 6 percent of total deposits had been withdrawn from Lithuanian banks. Leika said that the situation is stable now and that the withdrawals had a limited impact. He attributed many of these withdrawals to the older generation that remembers the Lithuanian banking crisis of the mid-nineties and wanted to store their money at home. Our local staff tell us they are aware of some acquaintances, mostly older individuals, who put their money in the proverbial mattress.

FIX IT OR GO BROKE

¶10. The incoming center-right government recognizes that its predecessor created a difficult economic situation. The outgoing Social Democrat coalition spent profligately. The new government, before even finalizing its Ministers, has already devised an economic plan to control spending. Highlights include:

- VAT (currently 18 percent), income tax (currently 24 percent) and corporate profit tax (currently 15 percent) will all change to 20 percent along with an elimination of VAT exemptions;

- Abolition of last year's indexing law which automatically adjusted government benefits according to the level of inflation;

- Reduction of the salaries of the President, MPs, Ministers, the PM and the State Ombudsman by an average of 15 percent;

- Cuts for federal and municipal budget expenditures on salaries by 12 percent, excepting teachers' wages;

- Allocation of 861 million Litas instead of the 1.91 billion Litas proposed by the outgoing government for teachers' salary increases;

- Reduction by 15 percent, on average, of the operational budgets of state and municipal institutions; and

- Reduction in social payments for all but the poorest Lithuanians.

COMMENT

¶11. Lithuania has only had impressive growth and enviable unemployment levels since 2005. In addition, the natural rate of unemployment in Lithuania might be around 6 percent according to Miliauskas. Thus, although unemployment might be rising it is not yet above a reasonable rate. The new conservative-led coalition's proposed steps towards fiscal discipline and its willingness to talk frankly about financial challenges are positive signs. Responsible government spending coupled with low overall debt rates for Lithuanians (only 10 percent have a mortgage and only 20 percent hold any type of debt) could leave the country in a good position when the economy recovers. The wild card is contagion, and the inability for some here and internationally to perceive that what happens in neighboring countries doesn't necessarily spell disaster for Lithuania. The world financial crisis will take its toll -- with

remittances from Lithuanians in London and Dublin likely to drop and increasing costs for interbank lending -- but it is still too early to say how big it will be.
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